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No. 89-530

In the Supreme Court of the United States

OCTOBER TERM, 1989

PORTLAND GOLF CLUB, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT

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QUESTION PRESENTED

Where a tax-exempt social club earns gross income from the sale of food and drink to nonmembers but reports a net loss from that activity because the total expenses allocated to it (both fixed and variable) exceed the gross income, whether the club can offset that loss against its net investment income in determining its "unrelated business taxable income" (26 U.S.C. 511-512) if the club lacks a profit motive in engaging in the sales to nonmembers because it does not intend that activity to generate income in excess of the total expenses allocated to it.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-3a) is unreported. The memorandum opinion of the Tax Court (Pet. App. 6a-42a) is unofficially reported at 55 T.C.M. (CCH) 212.

JURISDICTION

The judgment of the court of appeals (Pet. App. 4a-5a) was entered on June 1, 1989. On August 28, 1989, Justice O'Connor extended the time within which to file a petition for a writ of certiorari to and including September 29, 1989, and the petition was

filed on September 28, 1989. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner is a corporation exempt from income tax as a "social club" under Section 501(c)(7) of the Internal Revenue Code,[1] which grants tax-exempt status to "[c]lubs" that are "organized for pleasure, recreation, and other nonprofitable purposes" and meet certain other requirements. Petitioner operates a private country club that has a golf course, restaurant and bar, swimming pool, and tennis courts, primarily for the use of members and their guests. Nonmembers who are sponsored by members are permitted to use petitioner's restaurant and bar for banquets, receptions, and similar functions. Petitioner receives gross income that is unrelated to its exempt purposes—and hence subject to unrelated business income tax under Sections 511-512 of the Code—from two sources: sales of food and drink to nonmembers and interest upon its investments. Pet. App. 8a-11a.[2]

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[1] Unless otherwise noted, statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as in effect during 1980 and 1981, the tax years involved.

[2] The Code imposes a tax, at regular corporate rates, on an exempt organization's "unrelated business taxable income." I.R.C. § 511. The "unrelated business taxable income" of a social club is defined by Section 512(a)(3)(A) as "the gross income (excluding any exempt function income), less the deductions allowed by this chapter which are directly connected with the production of the gross income * * *." Because the "exempt function income" is confined to membership dues and other receipts from members (see I.R.C. § 512(a)(3)(B)), all of the income that a social club receives from nonmembers, as well as interest and dividends that accrue upon its investments, is subject to unrelated business income tax, whether or not the income derives from a trade or business. This treatment differs from that accorded by the Code to most other tax-exempt organizations, including charitable organizations granted exemption by Section 501(c)(3), whose "unrelated business taxable income" as defined by Section 512(a)(1) is limited to earnings from an "unrelated trade or business." See *United States* v. *American College of Physicians*, 475 U.S. 834, 837-839 (1986); *United States* v. *American Bar Endowment*, 477 U.S. 105, 109-110 (1986).

On its tax returns for 1980 and 1981, petitioner computed its gain or loss from the nonmember sales by deducting direct expenses (such as food and beverage costs, payroll, and supplies) that varied with the volume of the sales, and by deducting an allocable share of other, indirect expenses (such as taxes, depreciation, insurance, and other fixed overhead) that it would have incurred to operate its facilities whether or not it served nonmembers. The indirect expenses were allocated to the nonmember sales based on the ratio of petitioner's gross receipts from nonmember sales to its total gross receipts from sales of food and drink. Pet. App. 11a-13a. Petitioner's gross income from the nonmember sales exceeded the direct expenses of that activity, but was less than the sum of the direct and allocated indirect expenses, thereby generating net losses of $28,433 for 1980 and $69,608 for 1981 from its nonmember sales.[3] Those losses were greater than its interest income for those years. Petitioner offset the losses against the interest income, and it reported no unrelated

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[3] Petitioner likewise reported net losses from nonmember sales on its tax returns for every other year from 1975 through 1984 (Pet. App. 13a).

business income tax liability for 1980 or 1981. *Id.* at 21a-22a.

On audit, the Commissioner determined that the expenses allocated to nonmember activities were deductible by petitioner only to the extent of its income from those activities, but could not be used to offset its investment income. Accordingly, he asserted tax deficiencies of $1,828 for 1980 and $3,470 for 1981 to reflect the tax due on petitioner's investment income. Pet. App. 7a. The Commissioner reasoned that the expenses of nonmember activities are deductible to the extent they exceed income from such activities only if petitioner carries on the nonmember sales activity with a profit motive.[4] He found that petitioner lacked a profit motive for the nonmember activity because the prices of the food and drink were insufficient to recover the total costs allocated to such activities, so that such sales consistently yielded net losses. *Id.* at 22a-23a.

2. Petitioner challenged the Commissioner's determination in the Tax Court, which ruled in its favor (Pet. App. 6a-42a). The court held that the expenses allocable to petitioner's nonmember activities were

[4] The general rule under the income tax law is that the expenses of a not-for-profit activity may be offset against the income from that activity, but excess expenses may not be applied against income from other sources. See I.R.C. § 183; *Five Lakes Outing Club* v. *United States*, 468 F.2d 443, 446 (8th Cir. 1972) (allowance of expenses up to, but only up to, gross income from the related not-for-profit activity is "the procedure the Commissioner has long used with court approval"). Sections 163 and 164 of the Code, however, do permit the deduction of interest and taxes whether or not the taxpayer engages in the activity with a profit motive.

deductible in full.[5] Assuming (without deciding) that petitioner could deduct against other income its expenses from nonmember sales only if that activity was profit-motivated, the court found that standard satisfied because petitioner intended that the gross receipts from the nonmember sales would exceed the related "direct costs" (*id.* at 35a), *i.e.*, "the costs related to those sales which would not have been incurred absent those sales" (*id.* at 37a). See *id.* at 34a-42a. The court stated that the net losses consistently reported on petitioner's tax returns were not evidence that the sales lacked a profit motive, because those losses resulted "only by allocating a part of the expenses which petitioner would have in all events incurred," *i.e.*, the indirect expenses (*id.* at 37a-38a). Thus, although petitioner had allocated a portion of its fixed overhead expenses to its nonmember activity in order to generate the tax losses from that activity that it sought to deduct, the court permitted it to ignore those overhead expenses in determining whether it had the requisite profit motive with respect to the nonmember activity to claim such deductions (see *id.* at 38a-39a). The Tax Court relied heavily on its reviewed decision in *North Ridge*

[5] To be deductible under Section 512(a)(3), expenses must be "directly connected" with the conduct of the unrelated business activity. Under Treas. Reg. § 1.512(a)-1(c), where expenses are incurred or facilities are used for both exempt and nonexempt purposes, an allocation of depreciation, overhead, and similar expenses must be made on a reasonable basis. Once such expenses are so allocated to the nonmember activity, they are treated as if they are directly connected to the nonmember activity. The Commissioner did not challenge the allocation made by petitioner in this case; the parties stipulated that the allocation was reasonable (Pet. App. 12a-13a & n.5, 36a n.10).

Country Club v. *Commissioner*, 89 T.C. 563 (1987), rev'd, 877 F.2d 750 (9th Cir. 1989), where it had ruled that it would not evaluate a club's profit motive from the standpoint of "*taxable* profit," but would look instead to the "incremental increase in available funds" realized by the club from the activity (89 T.C. at 572).

3. The court of appeals reversed and remanded, on the authority of its opinion reversing the Tax Court in *North Ridge* (Pet. App. 1a-3a). In *North Ridge*, the court of appeals had noted that the question whether Section 512(a)(3) permits a social club to deduct expenses allocable to nonmember activity that lacks a profit motive "has produced a conflict of decisions between circuits" (877 F.2d at 753). Compare *Cleveland Athletic Club, Inc.* v. *United States*, 799 F.2d 1160, 1165 (6th Cir. 1985) (net losses allowable if nonmember activity carried on for "economic gain"), with *The Brook, Inc.* v. *Commissioner*, 799 F.2d 833, 839 (2d Cir. 1986) ("disagree[ing]" with Sixth Circuit's analysis because "a switch to an 'economic gain' test would give social clubs a tax advantage not enjoyed by other taxpayers"). The Ninth Circuit rejected the "economic gain" test of *Cleveland Athletic Club*, and agreed with *The Brook* that "a social club must pursue a nonmember activity with a profit motive before it can properly deduct its losses under section 512(a)" (877 F.2d at 754). The court grounded that conclusion upon the language of the statute, which limits a social club's deductions to those "allowed by this chapter," and upon the statute's legislative history, which it interpreted as requiring a social club's nonexempt income to be taxed according to the same principles that apply generally to all taxpayers under the Code. In particular, the court found that Section 512(a)(3) incorporates the principles of Section 162, under which expenses of the kind claimed by petitioner are not deductible (to the extent they exceed income) unless the business is conducted with a profit motive. *Ibid.*

The Ninth Circuit in *North Ridge* proceeded to hold that the profit motive test imposed as a condition to deducting excess expenses of a nonmember activity under Section 512(a)(3) is not satisfied unless a social club conducts that activity for "the production of gains in excess of all direct and indirect costs" (877 F.2d at 756). The court specifically rejected the Tax Court's view that a club's "intent to derive economic benefit from nonmember activity, before considering indirect costs," can satisfy the profit motivation requirement of the statute (*ibid.*). The court concluded that the Tax Court's interpretation of the statute would erroneously allow a portion of the club's nonexempt income to go untaxed, thus "manifestly" producing "the sort of tax-free subsidy to social club members that section 512(a) sought to prevent" (*ibid.*).

In this case, the court of appeals stated that the Tax Court had "appl[ied] the same standards we rejected in *North Ridge*," and accordingly it reversed (Pet. App. 2a). The court remanded to the Tax Court "for a determination of whether [petitioner] engaged in its non-member activities with the intent required under *North Ridge* to deduct its losses from those activities" (*id.* at 3a).[6]

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[6] Petitioner had argued in the Tax Court that it could have shown a net profit on its nonmember sales if it had chosen a different method of allocating the indirect costs to that activity—specifically, if it had allocated the costs according to actual use of facilities instead of gross receipts.

DISCUSSION

The court of appeals correctly held that petitioner, in computing its "unrelated business taxable income" under Section 512(a)(3), may not deduct the expenses allocable to its nonmember sales to the extent they exceed the income from such activities, unless the sales are carried out with an intent to make a profit. The court also correctly held that "profit" in this context means an excess of gross income over all properly allocated expenses, fixed as well as variable. We agree with petitioner, however, that there exists a conflict in the circuits on this issue; the decision below cannot be squared with *Cleveland Athletic Club, Inc.*, v. *United States*, 779 F.2d 1160, 1165 (6th Cir. 1985). Because this conflict involves a recurring issue of substantial administrative importance, we do not oppose the granting of certiorari.

1. Section 512(a)(3) does not independently establish certain expenses as deductible by a social club. Rather, it permits a social club to reduce its gross income by "the deductions *allowed by this chapter* which are directly connected with the production of the gross income" (emphasis added). Thus, it clearly provides no authority for deductions not permitted in other contexts by Chapter 1 of the Code. It is a cardinal rule under that chapter that expenses

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See Pet. App. 14a-16a. The purpose of the remand appears to be to allow the Tax Court to consider the argument that petitioner should be allowed to demonstrate a profit motive using a relatively stingy method of allocating fixed overhead expenses to its nonmember activity, under which the gross receipts from that activity exceed the expenses, and then use a relatively generous method of allocation on its tax return to produce losses from that activity that can be deducted against taxable income from other activities.

such as those claimed by petitioner here—costs of goods sold, payroll, depreciation, insurance, and similar items (see, *e.g.*, Pet. App. 11a)—are deductible only if incurred in connection with a trade or business or other profit-motivated activity. See note 4, *supra*; I.R.C. §§ 162, 167; *Commissioner* v. *Groetzinger*, 480 U.S. 23, 35 (1987); *United States* v. *American Bar Endowment*, 477 U.S. 105, 110 n.1 (1986); *United States* v. *Gilmore*, 372 U.S. 39, 44-46 (1963). Thus, petitioner's contention (Pet. 10-14) that Congress intended to confer a special benefit on social clubs by allowing them to take deductions not allowed to any other taxpayer—*i.e.*, "business" deductions even when not incurred in an activity conducted to make a profit—simply has no support in the statute, and it was correctly rejected by the court of appeals (see *North Ridge Country Club* v. *Commissioner*, 877 F.2d 750, 753-755 (9th Cir. 1989)).

The court of appeals was also correct in rejecting petitioner's contention (Pet. 14-17) that it can establish the requisite profit motive if it merely intended that the gross income from its nonmember sales exceed the variable costs of that activity. The established approach for determining profit motivation in assessing whether an activity is a "trade or business" is to measure gross receipts against *all* of the expenses of an activity—both variable and fixed. See generally *The Brook, Inc.* v. *Commissioner*, 799 F.2d 833, 838-840 (2d Cir. 1986). Moreover, the net losses from the nonmember sales activity that petitioner seeks to offset against its investment income result largely, if not entirely, from an allocation of fixed expenses to that nonmember activity. When it is the fixed expenses that are the very expenses claimed as deductions (on the theory that they are

"directly connected" to the nonmember activity (§ 512(a)(3)(A)), it defies reason to suggest that the same expenses can be ignored in making the for-profit determination necessary to support their deductibility.

The court of appeals' holding is further supported by the policy underlying Section 512(a)(3). Congress believed that it would be a "distortion" of the purpose for which social clubs are granted tax-exempt status if they were permitted to use "tax-free dollars" from interest, dividends, or other passive income accruing upon investments to subsidize the recreational interests of their members. H.R. Rep. No. 413, 91st Cong., 1st Sess. Pt. 1, at 48 (1969); S. Rep. No. 552, 91st Cong., 1st Sess. 71 (1969). Thus, social clubs, unlike most tax-exempt organizations, are subject to tax on their investment income (see note 2, *supra*). The net losses claimed by petitioner as offsets against its investment income are generated by fixed overhead that it must incur, irrespective of the nonmember sales, in order to operate its facilities for its members. Because every club has fixed overhead, petitioner's position would make it relatively easy for clubs to defeat the tax on investment income, thereby undermining a basic purpose of the taxation scheme of social clubs. See *North Ridge Country Club* v. *Commissioner*, 877 F.2d at 756.

2. We agree with petitioner (Pet. 7-8) that there exists a direct conflict in the circuits on the question presented. Three courts of appeals have now considered the question on similar facts. The Sixth Circuit has held that a social club's expenses allocable to sales of food and drink to nonmembers are fully deductible under Section 512(a)(3) so long as the sales activity is carried on for "economic gain," even

though it is not intended to produce income in excess of total costs. *Cleveland Athletic Club, Inc.* v. *United States*, 779 F.2d 1160, 1165-1166 (1985). The court stated that such expenses "need not necessarily come within the § 162 trade or business allowance, but rather, the deductions are allowable as ordinary and necessary to the production of income with a basic purpose of economic gain" (*id.* at 1165). The court added (*ibid.*): "We do not believe that the nonmember business activity must generate a tax profit."

The Second Circuit, however, reached the contrary conclusion on similar facts, holding that a social club's expenses from nonmember activity are not deductible to the extent they exceed income from that activity, unless the activity is pursued with a profit motive. *The Brook, Inc.* v. *Commissioner*, *supra*. The court specifically noted that it "disagree[d]" with the Sixth Circuit's decision in *Cleveland Athletic Club*, explaining that "[t]he mere fact that hobbies generate receipts, or 'economic gain,' does not entitle them to § 162 tax treatment," and that "a switch to an 'economic gain' test would give social clubs a tax advantage not enjoyed by other taxpayers" (799 F.2d at 839). The Ninth Circuit in *North Ridge* expressly noted this "conflict of decisions between circuits" (877 F.2d at 753), and it now has also explicitly "reject[ed] *Cleveland Athletic*'s holding that deduction of losses is allowed upon a showing of intent to derive 'economic gain' * * * because no provision in Chapter 1 of the Code allows loss deductions upon such a showing" (*id.* at 754). The court stated instead that it "agree[d] with the *Brook* decision" that a social club must demonstrate a profit motive for its nonmember activity in order to deduct

the expenses under Section 512(a)(3) (*ibid.*). The Ninth Circuit concluded that the profit motive test is not satisfied unless a club intends the gross income from nonmember sales to exceed all the costs, fixed as well as variable, that are allocable to the activity (*id.* at 756). This holding directly conflicts with that of the Sixth Circuit in *Cleveland Athletic Club*, where the club, like petitioner, received gross income from nonmember sales that consistently exceeded the direct expenses, but was less than the total expenses allocated to that activity (see 779 F.2d at 1161).

3. The question presented in this case is of considerable administrative importance. Because many clubs provide food and drink or other goods or services to nonmembers—at prices that do not exceed the total costs allocated to the activity—the practice of claiming losses arising from such activity as offsets against investment income is widespread. That practice substantially undermines the taxation scheme of Section 512(a)(3) by permitting social clubs to use their investment income as a tax-free subsidy for the costs of their member benefits. The volume of litigation on this issue demonstrates the need for resolution of the existing conflict in the circuits. More than 20 cases presenting the issue are currently pending in the lower courts, and the Internal Revenue Service advises that the issue has led to several hundred audits involving approximately $4 million of tax. Thus, resolution of the question presented here is critical to the evenhanded administration of the unrelated business income tax on social clubs.

We note that, because the court of appeals remanded this case for a determination whether petitioner meets the profit-motive test set forth in *North Ridge* (see Pet. App. 3a), the judgment below is interlocutory. The remand order leaves open the possibility that petitioner will prevail on its claim of deductibility on another theory—*i.e.*, if the Tax Court (or the Ninth Circuit on a second appeal) holds that a social club can establish the existence of the requisite profit motive by reference to another, less generous, expense allocation method, while continuing to use the more generous method reflected on its returns to compute the deductions that would be allowable in determining its unrelated business taxable income. While we do not believe that this alternative theory has merit, the remand is a factor that ordinarily militates against the granting of certiorari. See *Brotherhood of Locomotive Firemen* v. *Bangor & A.R.R.*, 389 U.S. 327, 328 (1967); *Hamilton-Brown Shoe Co.* v. *Wolf Bros.*, 240 U.S. 251, 257-258 (1916). Despite this consideration, however, we believe that certiorari is appropriate at this time. The decision below is irreconcilable with that of the Sixth Circuit in *Cleveland Athletic Club* on substantially identical facts, and permitting the conflict to persist until the remand proceedings in this case are concluded would unnecessarily prolong the uncertainty over the correct interpretation of Section 512(a)(3) in the numerous other cases in which this issue has already been raised or can be expected to be raised in the near future. Accordingly, we believe that, notwithstanding the interlocutory nature of the decision below, considerations of judicial economy and of achieving consistent treatment of similarly situated taxpayers make it appropriate to grant certiorari to resolve the conflict in the circuits.[7]

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[7] We note that the decision in *North Ridge*, which both the Tax Court and the Ninth Circuit treated as the lead

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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DECEMBER 1989

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case on this issue, is not interlocutory. The taxpayer there did not argue that it can prove the existence of a profit motive by using a different allocation for the profit motive determination from that used on its tax return to generate the losses that it seeks to deduct. Thus, the Ninth Circuit's decision in *North Ridge* finally disposed of the taxpayer's claim for the deductibility of its excess expenses, in direct conflict with the result in *Cleveland Athletic Club*, and the court did not remand for further proceedings. Because the taxpayer sought rehearing in the court of appeals in *North Ridge*, its time to petition for certiorari does not expire until December 26, 1989.

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